

Briefing Book

FY2005 Consensus Revenue Estimate Hearing December 8, 2003

Massachusetts Department of Revenue

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FY03 Results

- FY03 tax collections totaled \$14.964 billion, up \$676 million, or 4.7% from FY02. However, this growth was due entirely to income tax increases (a reduction in the personal exemption, suspension of the charitable deduction, and increases in the tax rate on capital gains) and changes to the corporate tax laws, including \$413 million in one time revenues, including amnesty proceeds.
- FY03 “baseline” tax collections (i.e., growth adjusted for the impact of tax law and administrative changes) were down \$300 million, or 2.1%, compared to FY02.
- FY03 tax collections were \$212 million above the FY03 revenue estimate, primarily due to higher than projected capital gains tax collections (which totaled about \$450 million in FY03, vs. an estimate of \$259 million) and revenues resulting from changes to the corporate tax laws. However, above forecast collections in these revenue sources were partially offset by lower revenues from withholding and other personal income taxes.
- Even though FY03 tax collections exceeded estimates, the two main sources of state tax revenue -- withholding and sales tax -- remained weak, after adjusting for the impact of tax law changes:
 - FY03 baseline withholding collections were down about 2%;
 - FY03 baseline sales tax collections were down about 1%.
- Corporate collections strengthened in FY03, growing by about 9% baseline.

FY04 Summary

- **Assumptions Underlying FY04 Consensus Tax Revenue Estimate**
 - FY04 **consensus estimate** (\$14.808 billion) assumed that the Massachusetts economy would begin a modest jobs recovery in the second half of FY04. “Baseline” revenues were projected to decline by 0.2% in the first half of FY04 and grow by 1.4% in the second half of FY04, for full year baseline growth of +0.5%.
 - **October 15th revenue revision** (\$14.796 billion) assumed the same general pattern of economic recovery, but with baseline revenue growth of 0.1% in the first half of FY04 and 1.0% in the second half of FY04, with baseline growth of +0.5% for the entire year. However, based on recently tabulated capital gains data for tax year 2002 (which results in an increase in the estimated value of the tax year 2003 capital gains tax increase), the October 15th estimate implies baseline growth between zero and 0.2% in FY04.
 - \$413 million in tax revenues received in FY03 were the result of one-time events, and will not be repeated in FY04. These events included the retroactive personal exemption decrease, suspension of the charitable deduction, the FY03 tax amnesty program and settlements due to changes in the corporate and inheritance tax laws.
 - The consensus and October 15th revenue estimates assumed that corporate tax law changes and the fully phased in capital gains tax increase would result in an additional \$270 million in FY04. However, data from recently received income tax returns indicate that the FY04 value of the capital gains tax increase will be \$50-\$84 million higher than originally estimated.

FY04 Summary

- **FY04 Results Through November 2003**

- Total tax collections of \$5.920 billion, up \$337 million, or 6.0%, compared to the same period in FY03, \$244 million above the November year-to-date benchmark set out in the October 15th revised revenue estimate.
- YTD baseline growth rate of +4.3%, primarily due to higher corporate tax collections and lower income tax refunds.
- Strong growth in corporate tax revenues, but continued weakness in withholding and sales tax collections, indicating that while corporate profits are recovering, so far in Massachusetts there has been a “jobless recovery”.
- Withholding performance is consistent with a loss of 48,000 - 70,000 jobs in the state (1.5%-1.9% of total employment) between October 2002 and October 2003, and average wage growth of less than 2% through the first half of calendar 2003 (the most recent period for which data available).

FY04 Summary

- **Forecast for Remainder of Fiscal Year 2004 According to Economy.com, Global Insight and the New England Economic Project**
 - According to vendor forecasts, job growth will begin in the second half of FY04; as compared to the last two quarters of FY03, employment will be up 0.2% to 0.7%, and wages and salaries will rise by 2.4% to 3.8%. This implies average wage growth of 2.2% to 3.1% as compared to the second half of FY03.
 - Based on actual tax year 2002 capital gains realizations, the tax year 2003 capital gains tax increase would bring in \$84 million more than is assumed in the October 15th revenue estimate. This assumes that tax year 2003 capital gains realizations are unchanged from tax year 2002.
 - However, it is reasonable to assume that some of the \$84 million tax increase will not be realized due to the fact that a higher capital gains tax rate makes investors less likely to realize their gains. Therefore, for the purpose of the forecast, it is assumed that only \$50 million in additional FY04 taxes will be realized.
 - There is also a considerable overhang of capital loss carryforwards that will dampen the growth of taxable capital gains, probably for several years into the future.
 - Using assumptions from Global Insight, Economy.com, and the New England Economic Project (NEEP), total FY04 tax revenue is estimated to be \$15.238 billion to \$15.285 billion, \$442 million to \$489 million above the October 15th FY04 estimate.

FY05 Summary

- **Fiscal Year 2005 (According to Economic Forecasters)**
 - Economic forecasters assume that national economic recovery will gather strength over the next 18 months. Forecasters assume that the Massachusetts economy will recover as well, but not as strongly as in the U.S. as a whole. Specifically, under these forecasters' assumptions:
 - Massachusetts employment will grow 1.2% to 1.6% over FY04;
 - Massachusetts wages and salaries will grow 4.5% to 5.4% over FY04, implying average wage growth of 3.3% to 3.8%;
 - Massachusetts personal income will grow 3.4% to 5.1% over FY04;
 - Nationally, corporate profits will grow 13.5% to 17.1% over FY04.
 - Using growth assumptions from Global Insight, Economy.com, and the New England Economic Project (NEEP), FY05 tax revenue is projected to be \$15.847 billion to \$15.937 billion, reflecting baseline growth of 4.0% to 4.3% over FY04.

Recent Revenue Trends

- **Two Measures of Tax Revenue Growth:**

- Actual growth - the difference between actual collections over two periods.
- Baseline growth - Growth had there been no tax law or administrative changes that affected tax collections. Baseline growth also adjusts for fluctuations in the timing of tax collections. Baseline growth is a better measure of the change in the underlying tax base and the economy.

FY04 Revenue Performance Through November 2003

	<u>Actual Growth</u>	<u>Baseline Growth</u>
Total Taxes	6.0%	4.3%
Income Total	7.6%	3.5%
Income Withholding	3.4%	0.4%
Income Estimated Payments	11.8%	2.7%
Sales	1.0%	1.3%
Corporate & Business	45.8%	45.1%
All Other	-4.1%	-0.6%

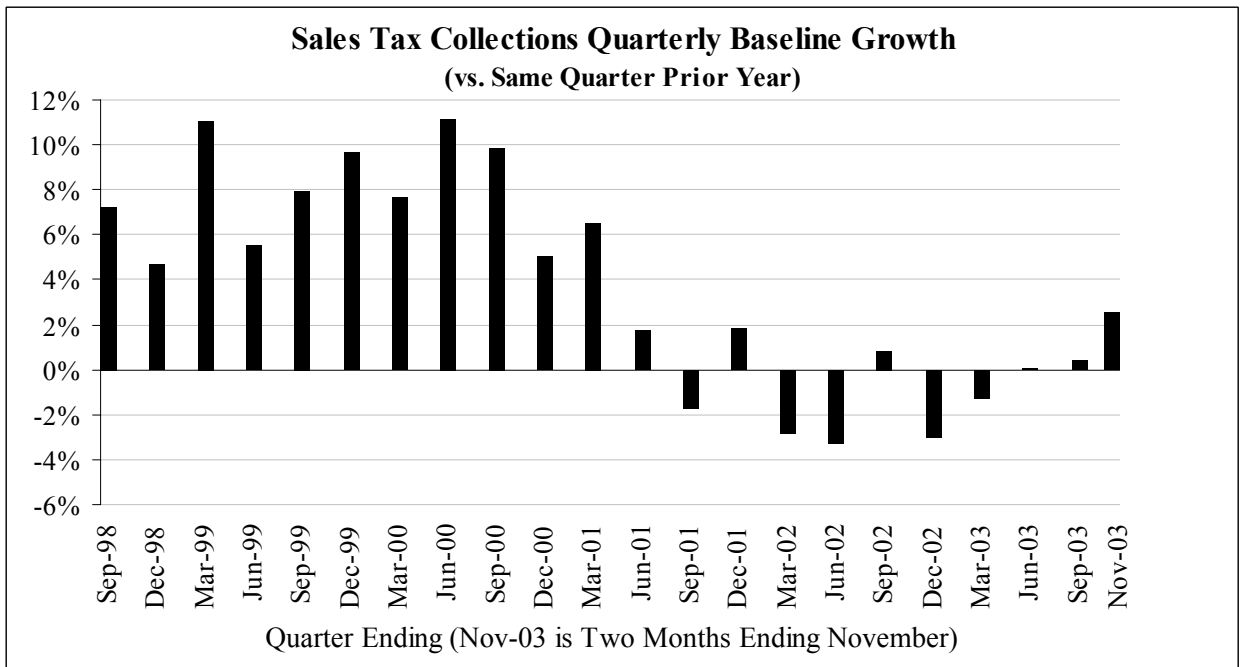
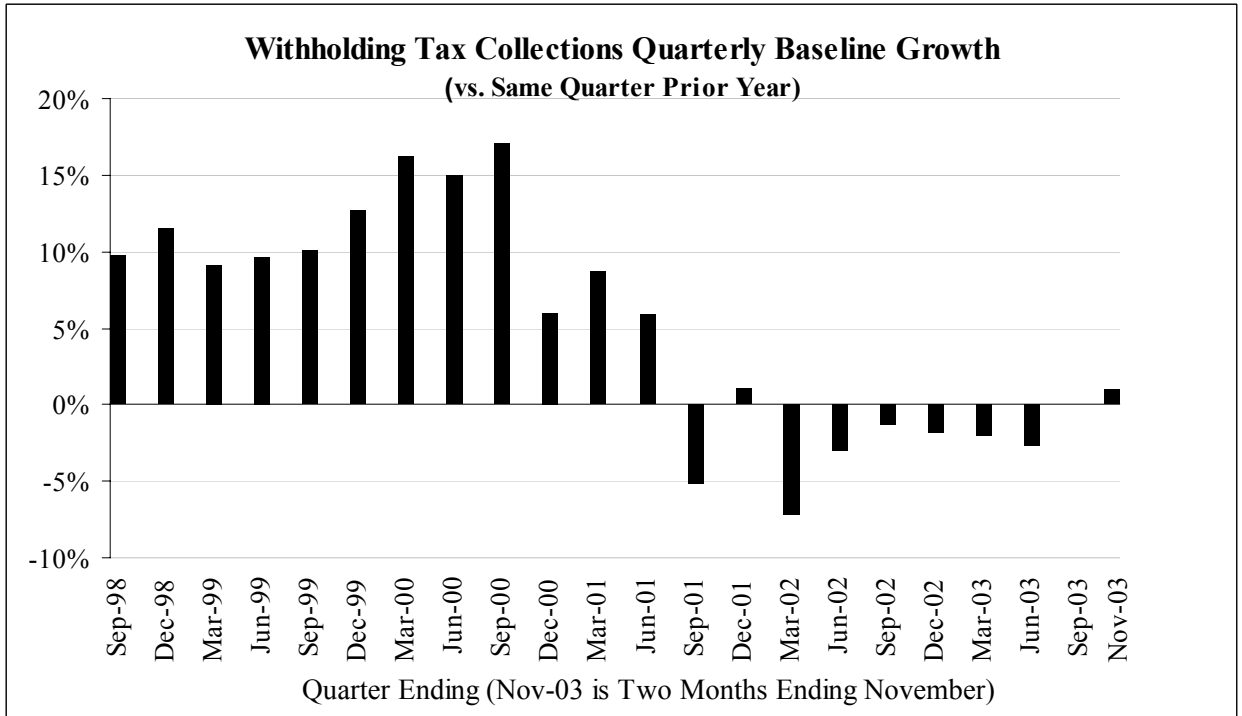
- **Withholding**

- Withholding flat due to job loss coupled with modest wage inflation.
- Bonus season is just starting, and will affect withholding collections from December 2003 through March 2004.

Recent Revenue Trends

- **Income Tax Estimated Payments**
 - Taxpayers have increased their estimated payments, presumably in response to the suspension of charitable deductions and the increased tax rate on capital gains, both of which increased tax liability.
- **Sales Tax**
 - Sales tax collections are up 1.3% baseline -- recession and job loss have led to stagnant growth in retail and business sales.
- **Corporate and Business Excise**
 - FY03 corporate and business taxes are up 45% baseline, primarily due to higher cash estimated payments (+19% baseline) and lower refunds (down 42% baseline) so far in FY03. However, it is possible that some of the corporate revenue resulting from tax law changes has come in earlier than projected, and thus has been “borrowed” from later in FY04. This amount is unlikely to have exceeded \$40 million, or less than half of the amount by which corporate and business tax revenues are above benchmark.

Recent Revenue Trends

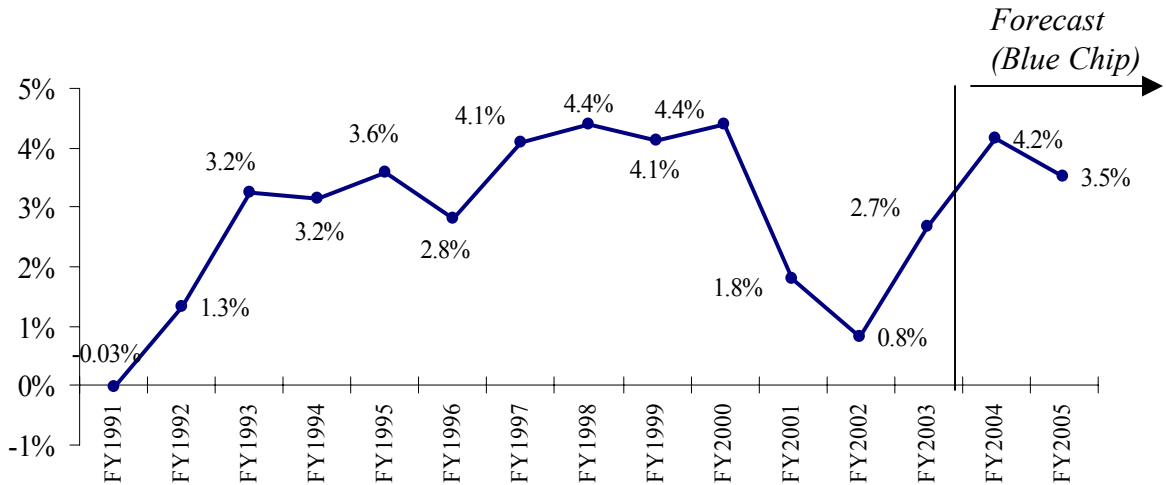


The U.S. Economy

- DOR utilizes national and Massachusetts state forecasts from Global Insight (formerly DRI-WEFA), Economy.com, the New England Economic Project (NEEP), and the Blue Chip Economic Indicators.
- The national recession ended in November 2001, and GDP growth has accelerated since then, with 2003 third quarter real GDP growing at an annualized rate of +8.2%.
- However, until recently job losses have continued, with more than 1 million jobs lost between the end of the recession and July 2003. Only in the last several months has the U.S. economy begun to add jobs, with employment growth of 290,000 since July.
- Although the stock market, as measured by the Wilshire 5000 total market index, is up 25% since December 31, 2002, its average value throughout calendar 2003 is actually 2% below its average value for calendar 2002. This average value is more important in forecasting capital gains taxes.
- The Federal Reserve has continued to keep short-term interest rates low, stimulating housing purchases and mortgage refinancing. This helped prevent the economy from falling into a deeper recession, and was a significant source of support to the Massachusetts economy.
- Most economic forecasters expect moderate growth in Gross Domestic Product (GDP) in FY04 and FY05, with the Blue Chip consensus forecast calling for real GDP growth of 4.2% for FY04 and 3.5% for FY05.

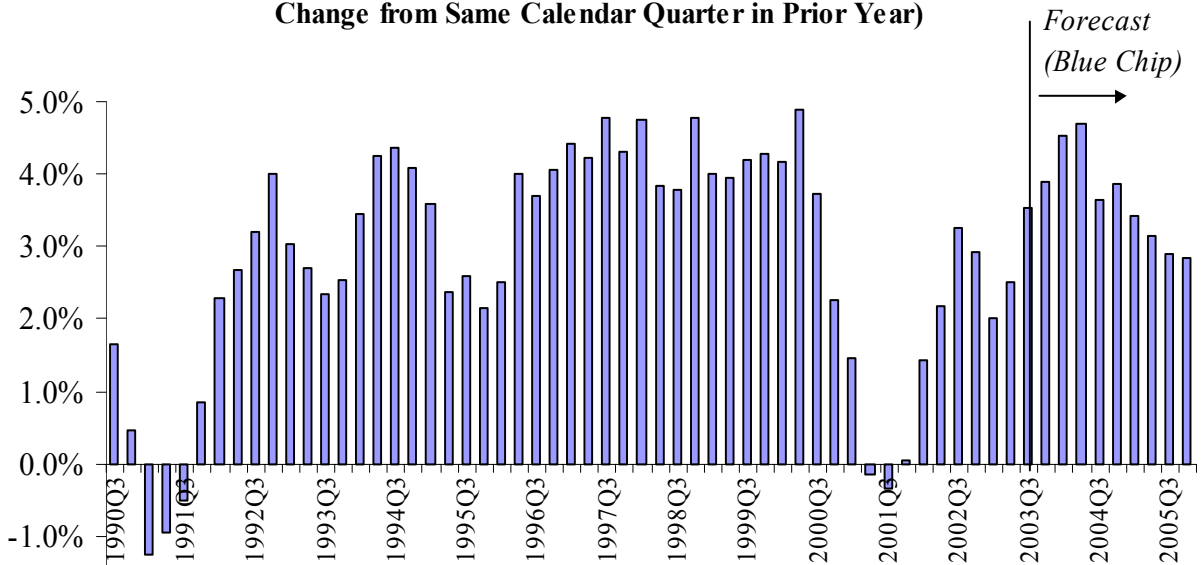
The U.S. Economy

Real GDP Growth Forecasts for FY04 and FY05



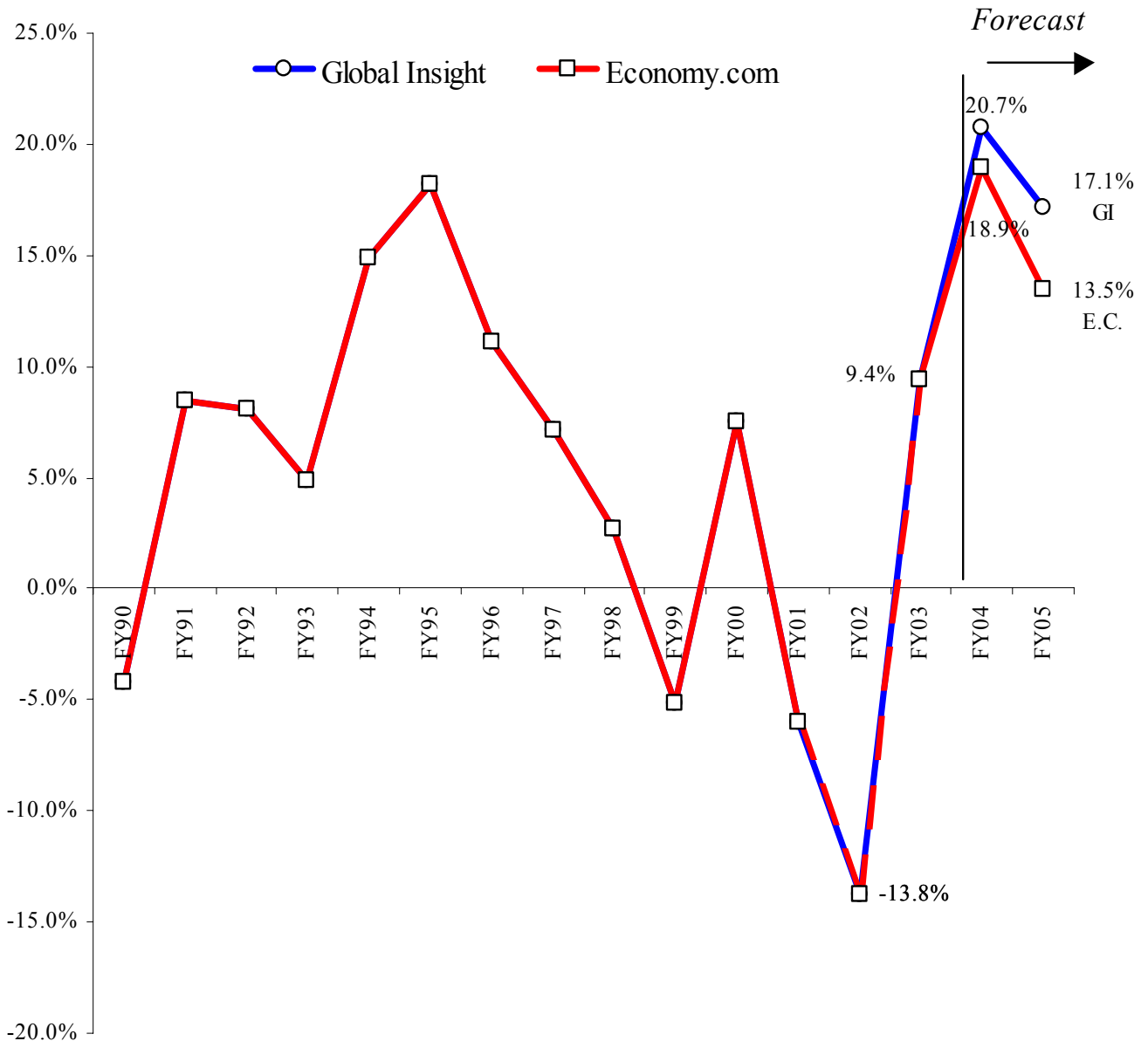
Consensus Forecast is for Moderate Economic Growth at the Beginning of FY04 and Slowing Through FY05

(November 10, 2003 Blue Chip Consensus Real GDP Forecasts, %
Change from Same Calendar Quarter in Prior Year)



The U.S. Economy

U.S. Corporate Profits Expected to Improve in FY04 and FY05

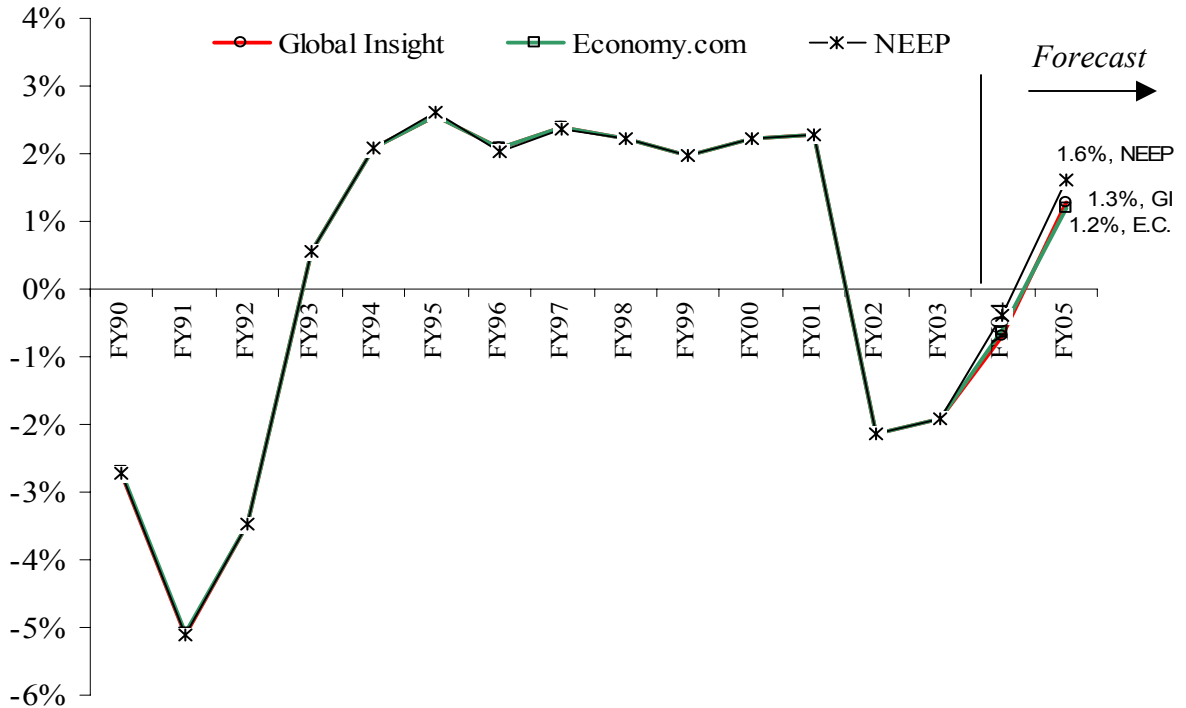


The Massachusetts Economy

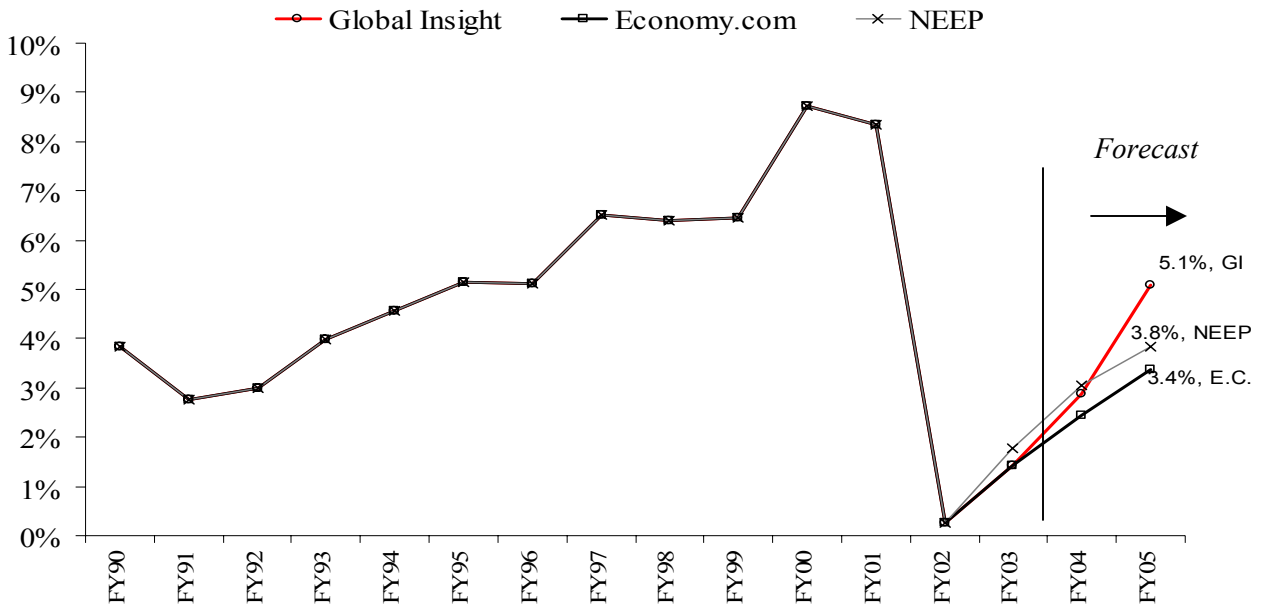
- The Massachusetts economy has not recovered as rapidly as the national economy. According to the “Massachusetts Benchmarks”, the state economy contracted each quarter starting in the first quarter of 2001 and ending in the second quarter of 2003, with slight growth in the third quarter of 2003, while the national economic recession began in March 2001 and ended in November 2001.
- According to official federal figures, the Massachusetts economy lost approximately 48,000 jobs between October 2002 and October 2003, a decline of 1.5%. However, based on more recent data not yet incorporated into the official data, job losses over the last year could be between 60,000 and 70,000, or 1.9% to 2.2%. Since the beginning of the recession, Massachusetts has lost between 180,000 and 200,000 jobs.
- The Massachusetts unemployment rate in October 2003 was 5.6%, up from a low of 2.5% in March 2000.
- Economic forecasters predict a moderate upturn in the Massachusetts economy starting in FY04 (see charts starting on page 15). While forecasting turning points is difficult, the most recently available national and state economic data indicate that the economy has at least bottomed out, making the forecast of an upturn more likely than it has been in the past several years. Growing average wages seem to confirm this potential turnaround.

The Massachusetts Economy

Massachusetts Employment Forecasts % Change from Previous Fiscal Year

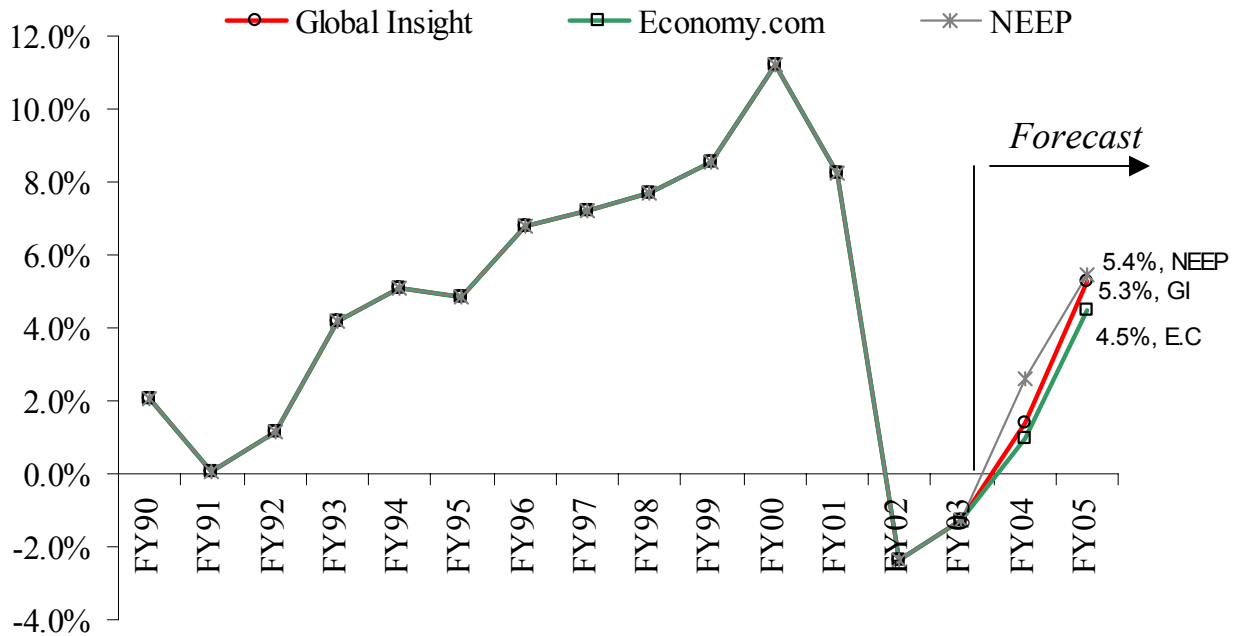


Massachusetts Personal Income Forecasts % Change from Previous Fiscal Year



The Massachusetts Economy

Massachusetts Wages & Salaries Forecasts % Change from Previous Fiscal Year



Massachusetts Economic Forecast Table

Data Adjusted for Estimated Job Loss Not Yet Reflected in Official Statistics

Percent Change is vs. Same Period in Prior Year

	History			Forecast			
	FY 2001	FY 2002	FY 2003	FY 2004			FY 2005
				First Two Quarters	Last Two Quarters	Full FY	
<u>US (Global Insight)</u>							
Real GDP	1.8%	0.8%	2.7%	3.6%	4.6%	4.1%	4.0%
Corporate Profits	-6.0%	-13.8%	9.4%	21.1%	20.3%	20.7%	17.1%
S&P500	-4.2%	-16.6%	-19.7%	15.1%	19.9%	17.5%	7.2%
Unemployment Rate	4.2%	5.5%	5.9%	6.1%	6.1%	6.1%	5.8%
<u>US (Economy.com)</u>							
Real GDP	1.8%	0.8%	2.7%	3.8%	4.9%	4.3%	3.4%
Corporate Profits	-6.0%	-13.8%	9.4%	16.7%	21.0%	18.9%	13.5%
SP500	-4.2%	-16.6%	-19.7%	15.1%	30.6%	22.9%	18.3%
Unemployment Rate	4.2%	5.5%	5.9%	6.1%	6.2%	6.2%	6.0%
<u>Massachusetts (Global Insight)</u>							
Real GSP	4.3%	-0.1%	3.2%	2.4%	3.2%	2.8%	3.9%
Wages & Salaries	8.3%	-2.3%	-1.3%	0.1%	2.8%	1.4%	5.3%
Personal Income	8.3%	0.2%	1.4%	2.0%	3.8%	2.9%	5.1%
Employment	2.3%	-2.1%	-1.9%	-1.6%	0.2%	-0.7%	1.3%
Unemployment Rate	2.9%	4.7%	5.5%	5.6%	5.6%	5.6%	5.6%
Housing Starts	-6.6%	-2.7%	-5.5%	5.2%	3.6%	4.4%	-5.5%
<u>Massachusetts (Economy.com)</u>							
GSP (real)	4.4%	-1.3%	1.7%	2.2%	4.0%	3.1%	3.4%
Wages & Salaries	8.3%	-2.3%	-1.3%	-0.5%	2.4%	1.0%	4.5%
Personal Income	8.3%	0.2%	1.4%	1.8%	3.1%	2.4%	3.4%
Employment	2.3%	-2.1%	-1.9%	-1.6%	0.3%	-0.6%	1.2%
Retail Sales	5.4%	1.3%	2.0%	4.3%	5.2%	4.7%	2.9%
Unemployment Rate	2.9%	4.7%	5.5%	5.6%	5.6%	5.6%	5.3%
Housing Permits	11.7%	0.1%	1.1%	0.4%	0.1%	0.3%	-0.6%
Home Sales	-5.1%	3.3%	-0.8%	1.4%	-7.8%	-3.2%	-13.7%
<u>Massachusetts (NEEP)</u>							
GSP (real)	4.4%	-2.6%	-0.7%	0.4%	2.7%	1.6%	3.6%
Wages & Salaries	8.3%	-2.3%	-1.3%	1.4%	3.8%	2.6%	5.4%
Personal Income	8.3%	0.2%	1.4%	2.7%	3.4%	3.0%	3.8%
Employment	2.3%	-2.1%	-1.9%	-1.4%	0.7%	-0.4%	1.6%
Retail Sales	5.4%	1.3%	2.0%	2.7%	4.0%	3.3%	3.2%
Unemployment Rate	2.9%	4.7%	5.5%	5.7%	5.8%	5.8%	5.4%

FY04 & FY05 Tax Revenue Projections

FY04 and FY05 Tax Revenue Projections Based on Assumptions of Economy.com, Global Insight, and the New England Economic Project (in \$ Billions)

	FY04	% Growth	% Growth	FY05	% Growth	% Growth
	<u>Projections</u>	Actual from	Baseline	<u>Projections</u>	Actual from	Baseline
		<u>FY03</u>	<u>from FY03</u>		<u>FY04</u>	<u>from FY04</u>
Economy.com	\$15.238	1.8%	3.3%	\$15.847	4.0%	4.0%
Global Insight	\$15.285	2.1%	3.6%	\$15.901	4.0%	4.0%
NEEP	\$15.275	2.1%	3.5%	\$15.937	4.3%	4.3%

Capital Gains Projections and Risks

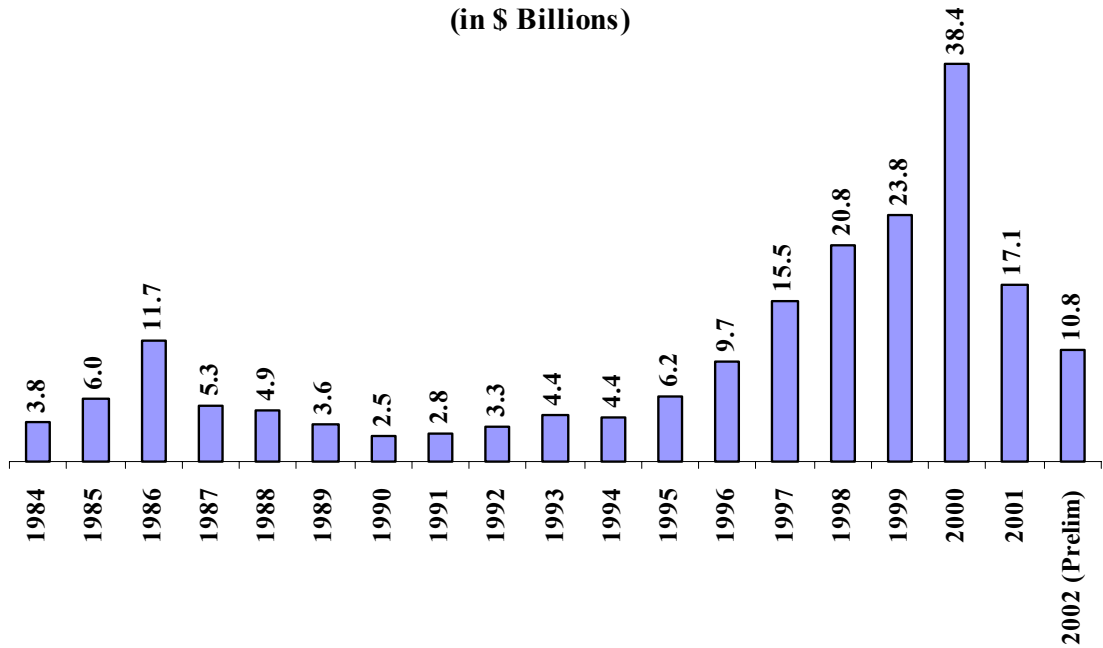
- Preliminary income tax return data for 2002 indicate that capital gains realizations declined to \$10.8 billion, from \$17.2 billion in tax year 2001, a drop of 39%.
- Capital gains taxes grew from \$337 million in tax year 2001 to \$448 million in tax year 2002, an increase of 33%. This increase was due entirely to the higher tax rate on capital gains implemented during tax year 2002, which resulted in increased tax collections of about \$250 million, most of which was received in FY03.
- In tax year 2002, Massachusetts had two long-term capital gains tax schedules, one for capital gains realized prior to May 1, 2002 (under which long-term gains were taxed on a sliding scale, depending on holding period) and another for gains realized on or after May 1, 2002 (under which long-term gains were taxed at 5.3%). In tax year 2003, all long-term capital gains were taxed at 5.3%. In tax year 2002, long-term capital gains realizations were taxed at an average rate of 3.7%.
- The three-year decline in the stock market has created large realized and unrealized capital losses that investors can use to offset their capital gains, thereby reducing or eliminating their capital gains tax liability. This large “overhang” of capital losses, though difficult to quantify, is a significant risk to the capital gains tax projections for FY04 and FY05.

Capital Gains Projections and Risks

- Economy.com (the only economic forecaster to estimate state capital gains realizations) estimates that taxable Massachusetts capital gains realizations will total about \$11.3 billion in tax year 2003, an increase of 4.4% from tax year 2002, and will total about \$11.6 billion in tax year 2004, an increase of 2.5% over tax year 2003.
- The consensus and October 15th estimates assumed that capital gains taxes would increase by \$81 million in FY04 due to the tax year 2003 capital gains tax increase. However, based on recently received tax year 2002 income tax return data, the tax year 2003 capital gains tax increase will result in \$165 million increase in tax revenues if capital gains realizations in tax year 2003 and 2004 are unchanged from their 2002 level. This would result in an FY04 and FY05 capital gains tax estimate of \$613 million (\$448 million + \$165 million).
- However, as mentioned on page 6, there could be a reduction in capital gains realizations due to the disincentive effect of the capital gains tax increase. Therefore, for the purpose of this forecast, the FY04 and FY05 capital gains tax estimates have been reduced by \$34 million, to \$579 million.

Capital Gains Projections and Risks

**MA Taxable Capital Gains Realizations, Tax Year Basis
(in \$ Billions)**



**MA Capital Gains Tax Collections, Tax Year Basis
(in \$ Millions)**

